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Manipulation

"If one truth concerning economic crises has been established in past years, it is that they are typically brought on by cheap money – i.e. low interest-rate policies that encourage excessive borrowing, excessive speculation and all the distortions and instabilities in the economy that these finally bring about."

The Failure of the "New Economics"
Henry Hazlitt, 1959

After their repeated failures earlier this year, the world's major central banks at last have succeeded in engineering a sustained rally in the U.S. dollar. As a result, market consensus has turned back towards to its traditional dollar bullishness, despite the steady, and we would say, inevitable deterioration in the economic fundamentals undergirding the American currency.

Clearly, the dollar's gains must be regarded as a short-term positive for all concerned. The Germans and the Japanese hope it will give a boost to their flagging economies. The Americans hope to make dollar strength a self-fulfilling trend that will lure foreign capital inflows into U.S. financial markets. This, it is believed, will give new life to the flagging bull market in bonds, and provide the Federal Reserve with additional room to cut interest rates if the U.S economy weakens further.

On Wall Street, much credit is given to the governments and central banks involved for their clever exploitation of the technical trends and chart points so closely watched by the currency traders. We, on the other hand, find it a bit shocking that central banks would stoop to such a level. Instead of trying to control and deter short-term speculators, it appears the G7 now seeks both to encourage and emulate them.

In any case, the more we reflect on the matter, the greater our doubts about the wisdom of dollar intervention on such a massive scale. To be sure, the operation has produced a wonderful bonanza for the likes of George Soros and other hedge-fund speculators who have built up long dollar positions. This windfall is all the more welcome to these dollar bulls, given the huge losses they suffered on their misguided bets last year.

But speculation is no substitute for sound fundamentals. We doubt the dollar's dramatic recovery will stimulate increased demand from longer-term investors. Logically, it should deter them, as they reflect on the fact that the dollar's surge is the artificial product of central bank manipulation – support that could be withdrawn at any time.

More importantly, intervention, no matter how massive and sustained, cannot correct the severe imbalances and excesses afflicting the dollar. By propping the greenback at an artificially high level, foreign central banks simply allow the Fed to pursue its traditional easy-money policies. This virtually guarantees a continuation of huge U.S. current-account deficits and long-term capital ouflows, keeping pressure on the dollar.

By the same token, the recent weakening of the yen will do little or nothing to resuscitate Japan's ailing economy and financial system. As we explain, hopes for a resurgence of Japanese private capital outflows into dollar assets are doomed to disappointment. If any thing, the weaker yen will tend to boost Japan's exports, setting the stage for the yen's next bull run.

A LOOK AT THE FUNDAMENTALS

Watching and heeding the recent commotions in the currency and bond markets, we think we should begin by reviewing a few facts and figures that illuminate the fundamental situation, particularly regarding the U.S. dollar. We think this all the more important, given the current euphoric mood towards the greenback.

As a starting point, let us look at the recent central bank interventions – the same interventions which have succeeded, at least temporarily, in restoring much of the dollar's losses from earlier this year. The best, though hardly complete, proxy for these interventions is the change in the amount of Treasury securities held by the Federal Reserve in custody for foreign central banks. These rose in the week ending August 16 by a stunning \$8.5 billion. Since the start of the year, they have jumped nearly \$80 billion.

But by no means is this the full story. The figures reported by the Fed include neither the Fed's own dollar interventions, nor the usually considerable dollar purchases by foreign central banks that end up as deposits with Eurobanks. Last year, for example, official dollar purchases amounted to \$91 billion, of which only \$34.5 billion went into Treasury bonds in the Fed's custody accounts.

The need for this massive, continuing dollar-support operation should be obvious. During the 1990-94 period, the United States ran a cumulative current-account deficit of no less than \$417 billion. Worse, these huge current-account outflows were topped by record-high capital outflows. U.S. long-term capital exports in the form of direct and portfolio investment amounted to no less than \$178 billion in 1993, and \$119 billion in 1994.

All together, outflows through the U.S. current account and long-term capital account generated a dollar supply on the international markets of \$282 billion in 1993 and \$272 billion in 1994.

These are the dismal fundamentals underpinning the dollar, the same fundamentals that led us at the beginning of the year to predict a looming dollar crisis. Essentially, to keep the dollar stable in the face of this stunning external imbalance, the United States needs to attract capital inflows that at least match the massive dollar outflows. Yet in our view, the sums involved far exceed what realistically can be expected in the way of private capital inflows.

This is hardly a recent development. For some years now, private capital inflows into the United States have fallen heavily short of the cumulative U.S. current- and capital-account deficits. Essentially, it has required bigger and bigger doses of central bank interventions to ward off a dollar collapse. During 1990-94, such official dollar purchases amounted altogether to \$243 billion, financing no less than 58% of the U.S. current-account deficit during that period.

Yet at the moment, the dollar bulls are celebrating just this sad fact. Determined central bank support, they rejoice, has placed the dollar on a new, upward path, one that is sure to lead it away from the post-World War II lows it touched just a few short months ago.

We find this attitude bizarre, to say the least. In truth, the dollar's situation has continued to deteriorate steadily throughout 1995, and particularly since July. This is indicated by the Fed's custody holdings, which jumped nearly \$27 billion in July alone, even as the dollar languished near its lows. Based on the unprecedented upswing in the Fed's custody accounts, it would appear foreign central banks bought up the entire dollar outflow stemming from the U.S. current-account deficit.

The ineffectiveness of these record-high interventions, which occurred mostly without coordination or publicity, must have disappointed the central banks concerned. Yet, given the Fed's determination to pursue an easy-money policy, intervention has been the only weapon available to them. Perhaps reflecting this situation, we have seen in recent

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (August 30)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	0.8%	11.7%	0.7%	-0.8%	17.2%
Canada	-1.7%	7.5%	4.2%	-3.8%	13.5%
France	-0.6%	2.1%	-7.1%	-7.1%	11.6%
Germany	0.4%	6.3%	1.2%	-1.3%	17.2%
Hong Kong	-3.3%	11.6%	-8.0%	-10.1%	31.2%
Japan	8.3%	-8.6%	-12.6%	-12.7%	24.4%
Mexico	3.1%	4.4%	-8.2%	-13.2%	71.3%
Spain	3.4%	-2.0%	4.1%	-1.5%	21.2%
U.K.	1.0%	14.3%	7.8%	-0.9%	19.0%
U.S.	-0.4%	22.1%	18.0%	-0.8%	25.9%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (August 30)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	9.17	-13	-87	-19	-154	54
Canada	7.99	-36	-115	-75	-169	31
France	7.34	-4	-93	-47	-109	9
Germany	6.68	-11	-94	-50	-107	20
Japan	3.27	29	-130	-169	-169	67
Spain	10.99	-35	-84	11	-160	12
U.K.	8.05	-18	-66	-45	-98	36
U.S.	6.33	-14	-149	-87	-170	31

Exchange Rates

Versus U.S. Dollar, % Change

Country (August 30)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia ($)	1.33	2.4%	-2.8%	1.3%	-3.1%	6.0%
Canada ($)	1.34	2.0%	4.4%	2.1%	-0.1%	5.9%
France (*f*)	5.07	-6.0%	5.0%	6.1%	-6.6%	7.1%
Germany (DM)	1.48	-6.8%	4.7%	6.2%	-9.2%	7.2%
Japan (¥)	99.1	-12.4%	0.5%	0.5%	-22.9%	2.2%
Spain (Pt)	126.3	-6.7%	4.0%	3.6%	-6.8%	5.9%
U.K. (£)	1.55	-3.5%	-1.3%	0.7%	-5.8%	0.7%

weeks an escalation in the use of the intervention weapon. The coordinated, massive intervention of August 14 was said to be consistent with the communiqué issued at the G7 summit in Halifax, in which the leaders of the world's economic powers declared their resolve to prevent "excessive dollar weakness not justified by the fundamentals." Yet what are the fundamentals, other than the massive dollar imbalances we have outlined above?

In reality, there is nothing mysterious about the dollar's weakness. The primary cause can be found in America's vastly excessive spending on foreign goods and assets. To finance this overspending, the United States requires higher and higher capital inflows from abroad, which have not been forthcoming. Actually, these inflows increasingly have fallen short of the rising dollar outflows, portending continuing balance-of-payments problems.

A CHANGE IN TACTICS

The recent interventions have done nothing to alter these underlying fundamentals. Indeed, by propping the dollar at an artificially high level, the central banks only worsen the existing imbalances.

The latest round of dollar buying was remarkable only in that it marked a change in tactics. By moving in a demonstrative, concerted way, and by striking at a time when the dollar was already rising against the yen, the central banks were able to avoid the appearance of desperation that marked their previous support operations.

Thus, instead of seeming an emergency measure – which it was – the latest intervention created the impression in the minds of short-term currency speculators that the central banks were serious about staging a reversal of the dollar's downward trend.

In theory, the dollar could be strengthened by curbing U.S. spending abroad. The appropriate policy would be monetary tightening. But in American eyes, monetary austerity, even on a relatively modest scale, is completely out of the question. Consequently, the U.S. position is that foreigners have the responsibility of funding America's international overspending spree by correspondingly increasing their lending or investing in the United States.

For various reasons, this solution worked reasonably well up until the late 1980s. However, since then it has failed, despite the stellar performance of the U.S. financial markets. Falling capital inflows have coincided with rising U.S. capital outflows, and a steady deterioration in the U.S. current account.

Evidently, the big question now is whether or not the recent dollar interventions, coupled with specific Japanese measures to foster private capital outflows, and repeated official declarations about the desirability of a strong dollar, have a chance to succeed for anything longer than a few weeks or months.

Our perennial skepticism about the feasibility of indefinitely financing the huge U.S. external deficit starts with the recognition that the task requires both a stable dollar and permanently attractive U.S. financial markets. This simply is an impossibility.

Looking at the financial markets, the 20% depreciation of the yen against the dollar obviously is an unexpected boon for Japan's manufacturing sector. Not surprisingly, Japanese stocks have soared in response. Conversely, the stronger dollar tends to hurt many U.S. businesses, squeezing their profits. This state of affairs is hardly conducive to a continuation of the bull run in U.S. stocks, and thus limits the attractiveness of U.S. markets. This in itself should impose a limit on the dollar's rebound.

Yet our bullishness over Japanese stocks is constrained by the realization that the strong yen is by no means the only factor depressing Japan's economy. In our view, it's not even the primary factor. Rather, Japan's woes can be traced predominately to a vicious domestic financial crisis that shows few signs of abating.

Credit growth, apart from government borrowing, is virtually at a standstill. Life insurance companies are on the brink of bankruptcy. The stock market remains grossly overvalued – even though it is down more than 50% from its 1989 peak. The feeble economic recovery achieved in 1994 is aborting. Fiscal policy has largely shot its reflationary bolt, while monetary policy remains stymied by the parlous state of the banking system.

AFTER THE BUBBLE

At the root of this overwhelming crisis, however, is not the strong yen, but rather the collapse of previously inflated real estate and stock prices, which served widely as loan collateral. The influence of this wholesale destruction of capital values on the economy and the financial system is far more pervasive than that of the strong yen.

The agonizing, drawn-out legacies of this crisis are two major adjustment processes, compounding each other and ravaging both the Japanese economy and the financial system. One of these adjustments itself is financial, and involves the necessary liquidation of the horrendous mountain of bad loans left behind by the bubble, a weight that currently is paralyzing the credit machine.

The other adjustment is taking place in the real economy, and consists of the liquidation of the equally horrendous over-investment in the business sector, in particular in the manufacturing sector and in commercial real estate. During the bubble years, when credit seemed both unlimited and virtually costless, investment climbed to 22% of GDP, after averaging just 15% in the prior decade.

In our view, the role of the strong yen in depressing Japan's economy is grossly overrated. Behind this exaggeration is the fallacious perception that Japan's economy is extremely export dependent. This is a myth. As a share of GDP, Japan's exports are no higher than U.S. exports. Both hover around barely 10% of GDP. If services are included, the U.S. export share is even higher. This compares with a German export ratio of about 33% of GDP. In fact, Japan's share of total world trade (10%) is below that of the United States (12.2%) and Germany (11%).

In the last analysis, the present Japanese economic and financial malaise is really the inevitable consequence of many years of ill-guided, excessive monetary ease. Obsessed with the perception that Japan's economic growth depends on strong exports, Japanese policymakers pursued a persistent policy of resisting yen appreciation with interventions and extreme monetary ease.

The disastrous result was the bubble economy of the late 1980s, with its rampant asset price inflation and extensive over-investment and mal-investment. Blinded by low inflation rates, policymakers woefully disregarded the distortions and maladjustments they were generating in the economy and the financial system. Blinded by exchange-rate optics, they failed to see that the Japanese trade sector was successfully coping with the yen's appreciation, thanks in large part to Japan's internationally superior productivity gains. In the end, policymakers sowed the seeds for the Bubble Economy, and for the biggest financial excesses of this century.

If sustained, the yen's substantial weakening surely will give Japanese manufacturers welcome relief by improving their damaged international competitiveness. But a weaker yen will do little or nothing to solve the far more important financial crisis.

WISHFUL THINKING ABOUT JAPAN

Before assessing the effects of the various measures taken to weaken the yen, we first would like to point out some flagrant errors in the prevailing perceptions and expectations.

The first misnomer is the widespread idea that the Bank of Japan has switched in recent weeks to a stance of extreme monetary ease, widely labelled as a policy of "printing money." The other misconception concerns the new measures taken by Japan's Ministry of Finance to promote capital outflows. Specifically, this has involved the loosening of certain accounting rules governing losses on foreign investments.

Even before the recent central-bank interventions, these measures had lifted the dollar somewhat, as international speculators anticipated they would unleash a flood of capital flows out of Japan and into world financial markets, in particular Wall Street. To quote one leading British newspaper, a "wall of money," originating in Tokyo, was said to be poised to tumble into foreign markets, pushing interest rates down and sending stock prices flying from New York and London to Buenos Aires and Hong Kong.

The first misconception we need to correct is the notion that Japan increasingly has failed to recycle its huge export surplus back to the rest of the world. By definition, this is impossible. Every surplus in a nation's current account must be matched by a corresponding capital outflow. They are mirror images of each other.

Seen in this light, it is not the overall size of Japan's capital exports that needs correcting. The problems lie rather in their source and their direction. What so disturbs Japanese policymakers is the fact that it increasingly has fallen on the Bank of Japan to provide the needed capital exports through its currency interventions.

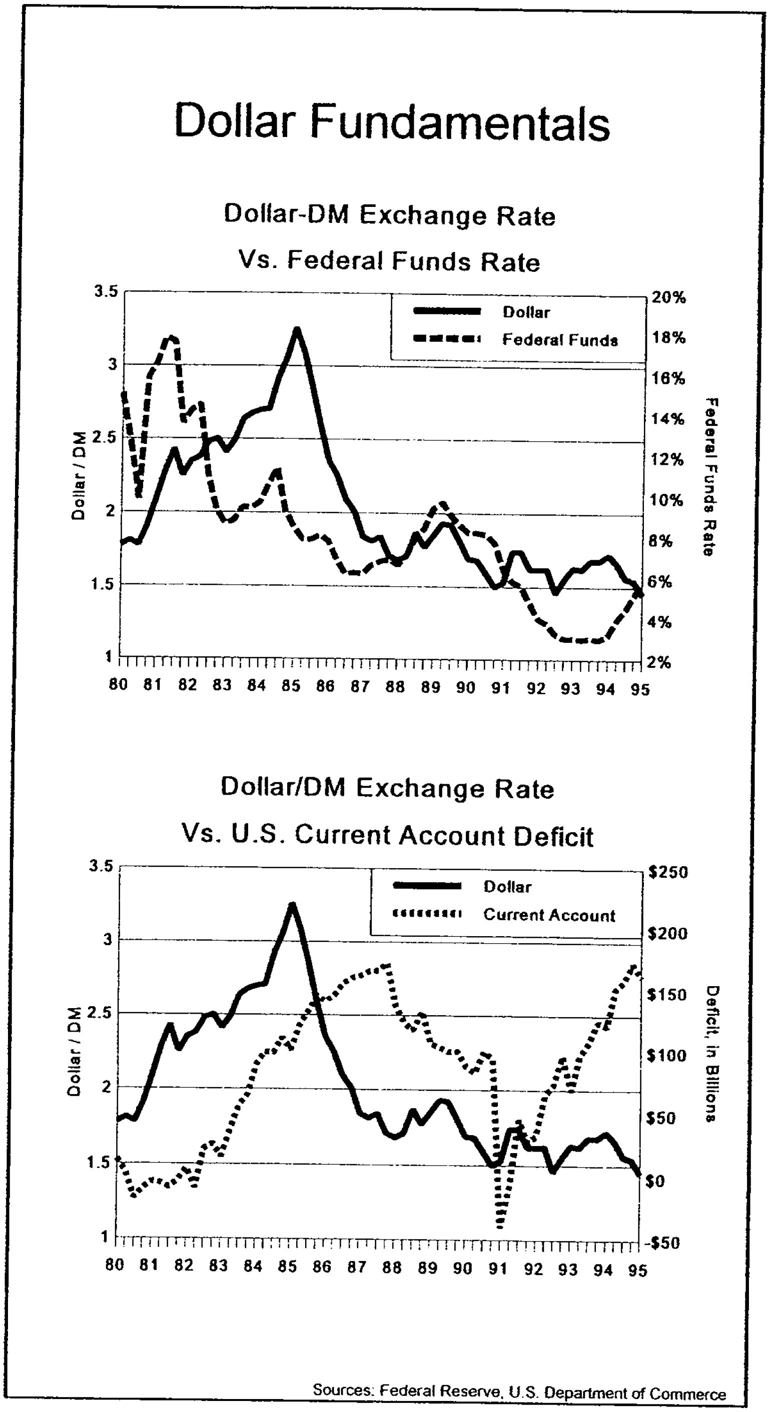
Accordingly, the primary objective of Japan's measures to foster capital exports is not to boost them overall, but rather to replace central-bank outflows with private outflows. It cannot be otherwise, because any overall rise implicitly would lead to a correspondingly higher current-account surplus. This being the case, it should be obvious that any increase in private capital flows will be offset by reduction in official capital flows. There simply is no wall of Japanese money waiting to be deployed into foreign markets.

What actually has been hurting the dollar is something else, namely, a shift in private Japanese capital exports away from U.S. markets to other regions, mainly the Far East and Europe. Associated with this has been a seismic shift in the currency denomination of the bonds purchased by Japanese institutional investors. During the 1980s, they primarily bought dollar bonds, a mistake which has cost them hundreds of billions of dollars in currency losses.

More recently, Japanese investors have turned in increasing numbers to yen-denominated bonds issued by borrowers in the Euromarkets. While yields on these Euro-yen bonds are substantially lower than yields on foreign-currency bonds, they are higher than on domestic Japanese bonds, while the purchaser stays comfortably in yen.

Foreign issuers, for their part, are drawn to borrow in yen because yen interest rates are far below domestic rates or competing foreign rates. Recently, for example, the Italian government launched a jumbo yen-bond loan totalling some ¥500 billion, or about $5.8 billion. The bonds were issued in 3-year, 10-year and 20-year maturities, with coupons ranging between 2.5% and 4.5%. To borrow in lira, by contrast, the Italians would have had to offer rates of between 10% and 11%. This amounts to a huge interest savings, and it also helps support the lira against the yen.

What the Japanese actually are doing is shifting the currency risk from their own shoulders to those of their borrowers, who will have to weigh this risk against the substantial savings to be had on interest costs. Historically, by the way, this risk typically has been borne by the borrower. The custom that lenders accept the risk, which developed after World War II, is quite unprecedented.



Flows of Japanese money into Euro-yen bonds are soaring as a share of Japanese capital exports. It must be realized that this trend is not at all supportive for the dollar. More than anything else, it tends to divert Japanese capital flows away from the United States. For the U.S. Treasury is obliged to borrow in dollars, while for U.S. corporations the current yield differential of about 3% between dollar and yen bonds is much too small to justify the inherent currency risk.

While Japan's efforts to boost capital outflows and the subsequent central-bank interventions have had truly sweeping short-term effects on the dollar-yen exchange rate, this really says very little about the long-term effects. It appears the initial wave of dollar buying was the work of short-term currency speculators, who bought on the expectation that they would be able to unload their dollars fairly quickly. In theory, they could sell them to Japanese or other international investors who need dollars to make genuine investments in U.S. assets.

But will theory work in practice? The crucial question is whether or not dollar manipulations will succeed in luring more long-term, private foreign capital to the United States. In this regard, the fact that market sentiment has turned in the dollar's favor is cited as a great positive.

But dollar bullishness is an old habit of the markets, albeit one that has worked less and less well in recent years. By now, we think it should be rather obvious to everyone that interventions and shifts in speculative expectations have lasting effects only when they are in accord with economic fundamentals and national policies.

Yet, the bulls might ask, didn't central banks successfully change the dollar's trend both in the 1985 Plaza Accord – when they drove it down – and in the 1987 Louvre Accord, when they stabilized and strengthened it? Why can't they succeed now?

A comparison of these past episodes with the present situation explains why what worked then cannot work now. The dollar fell in 1985-86 not because of the Plaza Accord, but rather because a soaring U.S. trade deficit was coupled with monetary easing. Conversely, what buoyed the dollar in 1988-89 was an improving trade balance and monetary tightening. These were the forces that made intervention successful for more than the short-run.

The point to see is that the interventions of the past two or three years all have been flagrantly at variance with the underlying trade and monetary conditions. This is even more true today. The U.S. trade and current-account deficits are stuck at near-record levels, and the Fed's monetary stance is extremely loose. The latest U.S. trade figures show a deficit of $63.8 billion for the first half of 1995, up from $49.9 billion in the first half of 1994. The measures taken to weaken the yen and strengthen the dollar contain absolutely nothing to correct these imbalances.

THE GLOBAL RECOVERY IS FALTERING

In our view, any true turnaround of the dollar is conditioned on a meaningful shrinkage in the U.S. current-account deficit. And in fact, one of the chief arguments of the dollar bulls is that slower U.S. economic growth will bring it down in the months ahead. We think they overlook the fact that the U.S. economy is not alone in slowing. In more and more countries, the global recovery of the 1990s is running out of steam. Major U.S. trading partners, including Canada, Mexico, Argentina, and Venezuela, either are in recession or struggling to avoid it.

It is true that while growth is turning increasingly anemic in the major industrial countries, the Far Eastern economies, with the exception of Japan, continue to forge ahead at an average annual growth rate of about 8%. From a currency point of view, however, there is a snag. The main source of imports for these countries is Japan, while their main export market is the United States. In other words, they use their large and soaring trade surplus with America to pay their huge and soaring import bill with Japan.

All told, the 10 major non-Japanese Asian countries ran a trade deficit with Japan of some $80 billion in 1994, up from $16 billion in 1985. This soaring deficit largely was offset by a soaring surplus with the United States – $60 billion in 1994, up from $25 billion in 1985. Cumulatively, these non-Japanese Asian countries generated a trade surplus with America totalling an astounding $375 billion during the 1985-94 period, and a cumulative trade deficit with Japan of $390 billion. America's overall deficit with Asia, including Japan, totaled about $950 billion between 1985-94, making up about 80% of the total U.S. trade deficit.

Since the Federal Reserve definitely will not tighten its monetary reigns to restrain U.S. overspending abroad, everything boils down to the question of whether Japan is willing and able to provide accommodation, either through higher private capital outflows or by curtailing its export surplus through the stimulation of domestic demand. In theory, this would increase Japanese consumption of imported goods, weakening the yen.

It can be hoped that the weaker yen will help Japan's economy by restoring some of its lost international competitiveness and removing the drag of diminished exports. But the irony is that the current "weak yen" policy stimulates precisely the wrong component of aggregate demand, namely exports. This, in turn, promises to power the next bull run of the yen.

What Japan primarily needs is stronger domestic demand, which would have to come from monetary and fiscal policy. However, there is no sign that this is forthcoming. Japanese authorities have been criticized, in particular by British and U.S. Japan experts, for failing to do enough to stimulate their economy. Above all, the Bank of Japan

is accused of pursuing far too tight a monetary policy. This is said to have robbed the Japanese government's massive deficit spending of its expansive effects.

The truth is that there has been most aggressive governmental action, at least in terms of interest-rate cuts and public deficits. Short-term interest rates are down to an all-time low of 0.8%, while the government balance as a share of GDP has turned from a 1% surplus in 1991 to a 5.3% deficit in 1994. But all of this has failed to work. Japan's economy is entering its fourth year of virtual economic stagnation.

In recent weeks, however, many foreign observers abruptly have changed their tune. All of a sudden, the Bank of Japan is being lauded for its new policy of "keeping the yen printing press rolling." *The Wall Street Journal* recently quoted one British expert on Japan to the effect that the only thing needed to revive the Japanese economy is to push the money button. The key argument now raised is that the Bank of Japan is finally pushing this button by switching from sterilized to unsterilized interventions in support of the dollar.

When a central bank buys foreign currencies, it ordinarily increases bank reserves. A rising supply of bank reserves tends to elicit a multiple expansion of bank loans or investments, creating in this process new bank deposits. This, in turn, raises the broader monetary aggregates – the money supply.

In the case of the Bank of Japan, critics previously complained that the bank was sterilizing its dollar purchases by selling Japanese government bonds in the open market. By selling bonds, the BoJ withdraws money from the banking system, thus leaving overall reserves unchanged. This is the practice which now is said to have undergone a revolutionary reversal.

JAPAN'S MONETARY MIRAGE

This sudden change of opinion on the part of foreign critics results from the fact that since early this year, the Bank of Japan's balance sheet has shown sharply rising bond holdings. Foreign observers have interpreted this as a deliberate switch to non-sterilized intervention. They hail this as a new policy of aggressive "money printing," one that at long last will prove effective.

It is true that in the past the Bank of Japan's currency interventions usually were sterilized through a corresponding sale of government bonds. Nevertheless, the banking system has experienced no shortage of excess reserves. These now amount to twice the required levels. Nor have reserve levels risen lately, despite the BoJ's bond purchases.

The fact is that the banks have no need for additional reserves, given currently depressed levels of lending and investing. Instead, banks are using any new reserves created by the Bank of Japan to repay their rediscount debts. In other words, whatever additional reserves the BoJ is pumping into the banking system through its open-market bond purchases are being recycled back through the discount window. For the BoJ, this amounts to a change in operational technique, not in policy.

In any event, what counts for the efficacy of monetary policy is not the level of bank reserves as such, but rather the extent to which commercial banks translate these reserves into credit and money expansion. By this gauge, monetary easing in Japan has proven completely ineffective. To use the metaphor of the 1930s, the Bank of Japan is "pushing on a string."

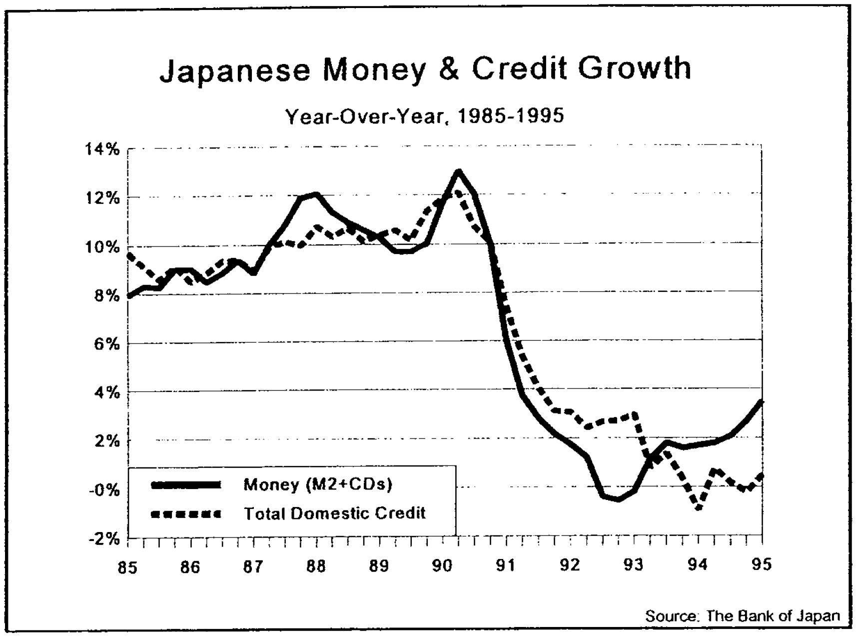
An examination of this failure leads us back to a famous dispute about the ineffectiveness of U.S. monetary policy in the 1930s, when American banks also failed to respond to rock-bottom interest rates and large excess reserves. Was this credit deadlock the inevitable consequence of previous financial excesses and economic maladjustments? Or was it the fault of then-current monetary policy?

For American monetarists, it is axiomatic that only present monetary policy matters. In their eyes, bygones always are bygones. The implies the conclusion that monetary policy is all-powerful, if only it is applied strongly enough.

This contrasts diametrically with the "classical" view – to which we subscribe – that the severity of depressions depends largely on the magnitude of the financial and economic maladjustments that developed during the preceding boom. Looking today at the Japanese economy, we see two major, painful adjustment processes: first, a savage "balance sheet" adjustment, necessitated by the collapse of capital values that have widely served as loan collateral; second, a savage "capital stock" adjustment that has to absorb and correct the vast over-investments and mal-investments left over from the bubble. The trouble is that monetary easing continues to be thwarted by two well-known phenomena of the 1930s: a "debt deflation" and a "liquidity trap".

BACK TO THE 1930s

What really fueled Japan's bubble were two monetary processes: a flight out of money, and a credit inflation. Essentially, the previous flight out of money into stocks and real estate has been followed by a flight in the opposite direction, into money balances and government bonds. This has led to the creation of a liquidity trap – a preference for liquidity so extreme that it virtually precludes any fall in interest rates or rise in asset prices, no matter how much money the Bank of Japan pumps into the banking system.



Japan's current debt deflation stems from the previous credit inflation. As they scramble for liquidity, corporations, financial institutions and individuals sell assets. But in doing so they depress asset prices even more, worsening their situation. This process is far from over. The slump in real estate prices – the collateral backing many Japanese loans – continues in full force. Stock market weakness only adds to the woes.

The crucial point here is that Japanese individuals and institutions cannot increase their overall liquidity, which consists overwhelmingly of bank deposits, the main component of broad money. Any rise in overall liquidity depends exclusively on the lending and investing activities of commercial banks. Only this can create new deposits. If the public as a whole desires more liquidity, only the banking system can provide it. But in Japan, as the chart above shows, credit creation in the private sector is completely deadlocked. When combined with Japan's exorbitant savings ratio, this is a perfect prescription for deflation all around and a huge, lasting export surplus.

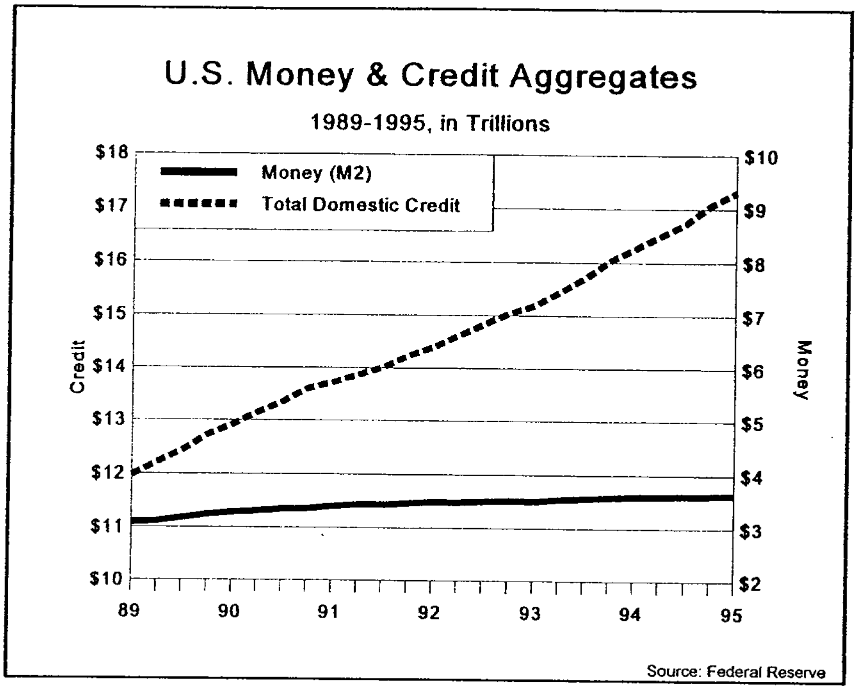
Since 1990, Japan has taken a massive dose of fiscal reflation, equal to about 6% of GDP. But any expansionary effects have been more than offset by the contractive effects of slumping business investment. This has turned the former corporate financial deficit of 9% of GDP at the height of the bubble years into a current surplus of 1% of GDP.

Given in addition Japan's high personal savings rate, the financial surplus of the private sector has soared to 10% of GDP, more than offsetting the exploding fiscal deficit, and thus creating the conditions for a rising export surplus. As a matter of fact, to the extent that the strong yen depresses Japanese business investment and stimulates investment abroad, it tends to raise, not lower, Japan's export surplus.

AMERICA'S MONETARY MUDDLE

In charting the course of Japanese monetary policy, we also need to keep an eye on U.S. monetary policy, which is its chief international counterpart. Here, too, the picture is confusing, but for the opposite reasons than in Japan. Measured against GDP, U.S. credit creation is more rampant than ever. But there has been an unprecedented divergence between debt creation and money creation.

Since the end of 1989, U.S. non-financial debt has expanded by $3.3 trillion, compared to barely $400 billion in broad money growth. Total debt, which includes the burgeoning use of leverage in the financial markets, has increased by no less than $4.6 trillion. This compares to nominal GDP growth of just $1.67 billion during the same period. This works out to a nonfinancial debt-to-GDP ratio of nearly 200%.



In other words, each dollar added to GDP over the past five years has involved the creation of two dollars of nonfinancial debt. Even for the debt-addicted U.S. economy, this is a new record. What puts this credit inflation in the most ominous light is the scarcity of U.S. savings. As in Japan, no change in this key economic fundamental is in sight, guaranteeing a continued large external deficit.

To make the U.S. monetary picture even more confusing, this record-breaking debt binge has been associated with record-low broad money growth. Since the end of 1989, broad money has grown at an average annual rate of 1.7%.

Many commentators like to view this modest money growth as evidence of the Fed's anti-inflation vigilance. But rampant credit expansion, booming financial markets and the current U.S. economic recovery give the lie to this view. It is soaring money velocity that has taken over.

The sluggishness in U.S. money growth is an outgrowth of various influences that have distorted the money supply heavily to the downside. The chief influences in this regard have been:

- A drastic shift in borrowing and lending away from banks to the capital markets and to non-bank financial institutions. Only bank lending increases the money supply.

- Substantial changes in bank funding. Until late 1994, U.S. banks relied largely on Euro-credits and short-term senior bank notes to finance their rapid credit expansion. Neither are counted in the money supply. Conversely, recent sharp increases in broad money reflect a big shift in funding back to deposits.

- Huge money outflows through the U.S. balance-of-payments deficits. These tend to decrease the money supply.

- A mass movement out of money balances and into securities. This in particular has fueled the U.S. bond and stock market booms.

Taking this entire list of influences into account, we would argue that U.S. monetary policy is far looser than it appears, and far looser than most people believe. But monetary conditions are following a very different pattern than in the past. Then, they were mainly determined by bank credit and corresponding money growth. Credit and money moved more or less in lockstep.

CREDIT AND MONEY PART COMPANY

But now, for the reasons previously explained, the two aggregates have separated company. Under these conditions, the aggregate that gives the best impression of the Fed's monetary stance, and of the pace of financial intermediation, is the growth in credit. People borrow to spend. Last but not least, the credit statistics also give us an idea of what the borrowed money is spent on: consumption, new investment, or existing assets.

As we remarked earlier, the U.S. economy is experiencing another credit and debt binge, now running at a rate of 200% of current nominal GDP growth – a new record. What's worse, this rampant credit inflation has been accompanied by a collapsing demand for money. Or, to express it in a more illustrative way: In search of higher yields, investors have switched massively from money balances into assets, particularly into securities. That's how there can be a bull market even with a stagnating or contracting money stock.

The nice part about such a mass movement out of cash and into securities is that it boosts security prices. The bad part is that in the long run it spreads illiquidity as investors become more and more overweight in illiquid securities at the expense of their holdings of liquid money balances. In fact, the share of liquid assets in the portfolios of U.S. private households has sharply declined during the 1990s.

For some time now, we have been watching this flight from cash with growing misgivings because its bitter end is inevitable. But, as long as the public continues to regard "cash as trash," the bull market can go on. As for the Federal Reserve, we think it ought to be far more conscious of the weakness in money demand as a sign of excessive monetary ease. First, such a collapse in money demand has exactly the same effect as an equal rise in the money supply. Second, such an abnormal stampede out of money simply has its limits. As sure as anything, there is bound to come a day when the American public once again will care about its liquidity. The longer the run lasts, the worse the inevitable reversal.

At present, there is a great divide among economists on the question of whether U.S. economic growth will continue to slow, or soon re-accelerate. Analysts also are debating the implications of one or the other scenario for the financial markets. Though most market participants cling to the so-called "soft landing" scenario, they are alert to even the most modest changes, altering their forecasts and expectations with each new piece of economic data.

For the past few months, the dollar bulls have looked for a comeback of the U.S. economy which would weaken bonds but help the dollar. But more recently, investors once again have started to anticipate a slowing economy, which would require further rate cuts by the Fed. This has buoyed the bond market, while central banks have shielded the dollar through their concerted interventions.

We, on the other hand, have stuck to our view, expressed earlier this year, that the U.S. economy is on its way into recession, despite extreme monetary ease. We see dangerous excesses in both the consumer borrowing binge and in the inflated financial markets. We absolutely exclude the possibility of a renewed, strong economic recovery. Accordingly, we expect neither higher inflation nor any further monetary tightening by the Fed.

A weakening economy and lower interest rates are bearish for the dollar. For bonds, on the other hand, this scenario is bullish, at least in principle. Yet from a fundamental perspective we still regard dollar bonds as considerably overvalued. The money flooding into the U.S. market does not spring from real savings. It flows overwhelmingly

from easy money and speculation. Additional rate cuts by the Fed are likely to unleash a new splurge of leveraged yield-curve playing, lowering long-term rates. Ordinarily, the dollar's chronic weakness would pose an obstacle to such a Fed easing. Yet in the face of the persistent, huge dollar purchases by foreign central banks, we are forced to admit that the normal rules may not apply any more.

CONCLUSIONS

Through massive intervention, the G7 authorities have arrested the dollar's near-collapse, and even succeeded in manipulating a short-term rally. But have they changed the greenback's fundamental trend? We think not. Indeed, we would say the dollar's recent, sharp gains have increased, not decreased, the risks of a dramatic dollar rout. The next few weeks will offer a crucial test of the success of failure of the G7's ploy. A failure by the greenback to hold its recent gains would, in our view, send an extremely bearish signal.

The economic fundamentals for the dollar, as we have explained and documented, are as adverse as ever, if not worse. The Fed remains locked into a course of excessive monetary ease, while Japan – the indispensable source of the foreign capital needed to finance the American current-account deficit – remains locked in financial paralysis. This obstructs any hope of economic recovery, and rules out a resumption of large-scale private capital outflows.

It appears to us that up until this point the dollar rally has been driven almost entirely by short-term players. Yet from a technical standpoint, the greenback is clearly overbought. The hedge funds and other currency speculators are waiting to see if longer-term investors will jump aboard the bandwagon. This, it is hoped, will power another leg in the rally, allowing speculators to exit their huge long positions.

Will this come to pass? Again, we think not. Japanese institutional investors are incapable of generating the capital outflows necessary to move the dollar higher. In any case, private outflows would lead to further dollar gains only if they were not offset by a reduction in the Bank of Japan's own purchases. We find this extremely implausible.

For now, the threat of central bank action prevents a dollar reversal. But we see little reason to expect further gains for the greenback from that source. Certainly, the Japanese would like to see the yen weaker still. But we doubt American officials would support or tolerate further dollar appreciation, given the weakness in the U.S. economy.

Sooner or later, we think, the short-term speculators will grasp these essential points. This creates the potential for an abrupt scramble for the exits, and a plunge that could carry the dollar below its lows from earlier this year. Accordingly, we think dollar-based investors should view the current rally as a gift from the central banks. We recommend using it as an opportunity to switch into the cash and short-term bonds of the hard-currency countries, primarily Germany, Switzerland, Austria and the Netherlands.

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